Linking Overtrading Activity with Accounting Principles and Procedures

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Accounting procedures always changes according to the transformations in business environment. In all cases, the changes are always consistent with the existing accounting principles or standards. One such example is the overtrading activity that can happen in exchange transactions of similar non-current assets. Using the overtrading activitiy as an example, this article relates the change in accounting procedures to account for valuation discrepancy intrinsic in this activity to accounting principles. In other words, the article aims to show how theory guides practice. Indirectly, it also illustrates the operationability of accounting principles from a practical perspective as many argue that what they learn in university is mere theory and not practical. I chose the overtrading activity because this is an uncommon practice that happens only in certain situations and to assert that, even for a rare practice like this, we have theories to guide the accounting procedures. It is also to highlight that the principle-based accounting standards would have captured the effect of this activity on the reliability of accounting information and automatically, triggered changes to accounting procedures to right the wrong. Where as, the rule-based accounting standards require a new rule being introduced to account for this change.

One of the fundamental qualitative characteristics explained in the International Accounting Standard Board's (IASB) conceptual framework is faithful representation, previously know as reliability. Faithful representation means the

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information provided in financial statements should be free from bias, omission and any material misstatement. It must be able to reflect exactly the transactions that had taken place during the past accounting period and presents a true and fair view of the business entity's financial performance and position. In this way, the business accounting function earns credibility and favourable reputation from the external environment. Business tends to benefit greatly as high investor confidence can translate into many business-related advantages.

Now, let us examine how the need to abide by the faithful representation principle has changed the accounting procedures in a disposal of asset transaction that involves overtrading activity. Accounting for disposal of asset requires the determination of gain or loss that will be recognized as part of the profit or loss in the year of the disposal. Any overstatement or understatement of gain or loss would invariably affect the business income pronouncement in that year. It would mean that the income information is not faithfully represented any more. Assuming that the amount is material, users' decisions based on the unreliable information may become detrimental. Thus, these gains or losses have to be calculated correctly during disposals.

When assets are disposed through an exchange transaction, the cost of the new asset acquired through the exchange is equal to the trade-in value of the old asset plus the additional cash given. Where as, the carrying amount of the old asset is equal to the original cost of the old asset less the accumulated depreciation of the old asset up to the date of disposal. Therefore, the gain or loss is calcualted by taking the trade-in value minus the carrying amount of the asset. A gain is recorded when the trade-in value exceeds the carrying amount and a loss is incurred when the reverse happens. The accounting procedures recognise both the gain or loss and record in the accounting books to the effect. To understand better, let us work with an example.

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Example 1:
Loss on disposal in an exchange transaction

The following information of KVK Company has been provided:

	RM
Cost of old vehicle	100,000
Accumulated depreciation of old vehicle	80,000
Trade-in value of old vehicle	18,000
Purchase price of new vehicle	120,000

Calculation of gain or loss:
= Trade-in value – Carrying amount
= 18,000 – (100,000 – 80,000)
= RM2,000 (Loss)

Journal entries to record the disposal and the loss:

	RM	RM
Vehicle (New)	120,000	
Accumulated depreciation	80,000	
Loss on disposal	2,000	
Cash		102,000
Vehicle (Old)		100,000
(Traded in old vehicle for new vehicle)		

Example 2:
Gain on disposal in an exchange transaction

The following information of KVK Company has been provided:

	RM
Cost of old vehicle	100,000
Accumulated depreciation of old vehicle	80,000
Trade-in value of old vehicle	25,000
Purchase price of new vehicle	120,000

Calculation of gain or loss:
= Trade-in value – Carrying amount
= 25,000 – (100,000 – 80,000)
= RM5,000 (Gain)

Journal entries to record the disposal and the loss:

	RM	RM
Vehicle (New)	120,000	
Accumulated depreciation	80,000	
Gain on disposal		5,000
Cash		95,000
Vehicle (Old)		100,000
(Traded in old vehicle for new vehicle)		

The above accounting treatment shows the common recording procedures for disposal of assets through an exchange transactions. It assumes that the transactions occurs at arms length without any inflating of prices. However, this recording procedures has not taken into account about what transpire in an overtrading activity. The overtrading activity is normally used as a marketing tool to improve sales. In today's business environment, dealers are always vigil in seeking new marketing strategies to boost their sales. Overtrading activity emerges as a result of dealers' high competitive environment and their desire to push their product to customers. Overtrading activity usually happens in exchange transactions as illustrated here. In order to push their product, the dealers tend to overtrade, that is, offering a higher trade-in value compared to the actual fair value of the product. Since the overtrade value is not a true reflection of the fair value, any gain recognised would render the income to be unreliable. Inherently, overtrading can be assumed as bias valuation. Using overtrade value to account for a gain from disposal means providing bias information. The accounting principle of faithful representation requires neutral information. Hence, overtrade value is not consistent with the faithful representation principle. How this is captured in accounting procedures?

Accounting procedures has changed to capture the changes that had taken place in the business environment. The loss from disposal is recognised as shown in Example 1 as per the prudence principle, but the gain is not recognised in view of this overtrading activity. The gain will be deferred over the useful life of the new asset. Thus, the journal entry will be:

	RM	RM
Vehicle (New)	**115,000**	
Accumulated depreciation	**80,000**	
Cash		**95,000**
Vehicle (Old)		**100,000**
(Traded in old vehicle for new vehicle)		

You will notice that the cost of new vehicle has been reduced by the amount of the gain (RM5,000). The gain is spread over the useful life of the new vehicle in the form of reduced depreciation. Assuming that the vehicle useful life is 10 years with no residual value, its annual depreciation would be:

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Old method with gain recognised:

$$Annual\ depreciation = \frac{120,000}{10} = RM12,000\ per\ year$$

New method with gain not recognised:

$$Annual\ depreciation = \frac{115,000}{10} = RM11,500\ per\ year$$

The difference in the amount of depreciation amount of RM500 is attributed to the deferred gain from disposal, that is:

Gain from disposal deferred:

$$= \frac{5,000}{10} = RM500\ per\ year$$

The overtrading activity has been given as example to justify recording procedures for gains from disposal in an exchange transaction of similar assets. The general guidelines for exchange transactions involving non-current assets are:

For exchange of dissimilar non-current assets:

Gains or losses will be recognised immediately as shown in Example 1 and 2.

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For exchange of similar assets:

Losses will be recognised immediately as in Example 1
Gains will be deferred over the useful life of the new asset by way of a reduced depreciation amount.

In this article, I have aimed to achieve four objectives. These are:

- The application of a fundamental qualitative characteristic, the faithful representation (formerly known as reliability)
- Practice will subscribe to theory. It is very rare that it doesn't. Only the methods of doing things will vary according to industries and management expertise.
- The advantage of a principle-based standards over a rule-based standards.
- For students, the accounting procedures to record the exchange transaction of non-current assets.

In summary, as business environment changes, the practice (accounting procedures) also changes, but it is always in accordance to theory (principles / standards). If there is no theory to support a change, then the academicians would be quick enough to identify the dearth. They would research and offer a valid theory.

The writer is the founder and content manager of www.kvk-accounting.com who advocates strongly on building cognitive thinking skills via better understanding of accounting concepts and simulating artificial intelligence process of learning from experiences. He views his exercises as a form of providing these learning experiences.

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